Applying P.L. 86-272 In a Modern Economy

by Jeffrey A. Friedman and Michele Borens

In 1959 a gallon of gas was 25 cents; Mattel introduced the first Barbie doll; the commercial copier and mainframe computer were introduced; Alaska and Hawaii became the 49th and 50th states, respectively; and the Boeing 707 jetliner came into service. In a developing and traditional manufacturing economy in which many of the luxuries of modern technology we know today did not exist, Congress enacted 15 U.S.C. section 381, et seq., commonly known as Public Law 86-272, to protect traditional businesses. The federal statute allows interstate businesses to solicit sales of tangible personal property in states without triggering an income tax return filing requirement. In today's economic environment in which iPods, e-readers, and cellphones are staples, the application of P.L. 86-272 is just as relevant.

We will first provide an overview of P.L. 86-272 and then discuss applying P.L. 86-272 in a modern economy in which digital and intangible property and service-based businesses are prevalent. Finally, we will discuss how evolving income tax regimes (for example, combined reporting and gross-receipts-based taxes) have created additional challenges in applying P.L. 86-272.

Background

In 1959, just seven months after the U.S. Supreme Court handed down its decision in *Northwestern States Portland Cement Co. v. Minnesota,* 358 U.S. 450 (1959), Congress enacted P.L. 86-272, setting forth the minimum standard for imposition of a state net income tax in certain situations. P.L. 86-272 states:

> no State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:
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> - the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and
> - the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described [above].[1]

Taxpayers that limit in-state activities to solicitation of sales of tangible personal property (if the sales are accepted and shipped from outside the state) are exempt from the state's net income tax. Notably, this federal statute does not apply for taxes other than a net income tax, and the protection is lost if the seller sells items other than tangible personal property (for example, intangible property or services).

P.L. 86-272 also applies to independent contractors and allows for the use of an in-state office.[2]

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[1]P.L. 86-272 expressly excludes from protection domestic corporations — those corporations that are incorporated under the laws of the state.

[2]An independent contractor is defined as "a commission agent, broker, or other independent contractor who is engaged

(Footnote continued on next page.)

Thus, not only does P.L. 86-272 apply to activities by independent contractors, but independent contractors are in some circumstances afforded greater protection.

While P.L. 86-272 is limited to solicitation of sales of tangible personal property, Congress contemplated that some "ancillary activities" could be conducted within the state without violating P.L. 86-272. The Supreme Court further clarified which activities may be ancillary to solicitation as opposed to serving an independent business purpose in *Wisconsin Department of Revenue v. William Wrigley, Jr. Co.*, 505 U.S. 214 (1992). In *Wrigley* the Court held that an Illinois-based manufacturer was subject to Wisconsin franchise taxes and was not protected by P.L. 86-272 because the activities of its sales representatives in Wisconsin in replacing stale gum, supplying gum through "agency stock checks" (for which the retailer was charged), and storing gum were not ancillary activities. The Court in interpreting "solicitation of orders" rejected Wisconsin's contention that solicitation includes only those activities that are strictly essential to making requests for purchases. Rather, solicitation covers activities that are entirely ancillary to requests for purchases (those that serve no independent business function apart from their connection to the soliciting of orders) and those activities that the company would have reason to engage in anyway but chooses to allocate to its in-state sales force.

In 1986 the Multistate Tax Commission issued its "Statement of Information Concerning Practices of the Multistate Tax Commission and Signatory States Under Public Law 86-272."[3] The statement of information provides an extensive list of protected ancillary activities and those activities that are unprotected and thereby nonancillary. The statement of information also said that some unprotected nonancillary activities, when taken together, may be de minimis and thus do not exceed the protections afforded by P.L. 86-272.

Digital Property, Intangible Property, Services — The New and Improved Kids on the Block

In 1959 encyclopedias were series sold by door-to-door salespeople. Today, an encyclopedia user may download or purchase the information on the Internet. Whether the downloaded versions of books, movies, music, and other items constitute tangible personal property for purposes of P.L. 86-272 is a threshold question in applying the law.

P.L. 86-272 provides protection only for solicitations of sales of tangible personal property and not solicitations of services or the licensing of intangibles. State income tax statutes and regulations generally do not define tangible personal property for corporate income tax purposes. Furthermore, tangible personal property is not defined by P.L. 86-272.

Despite the importance of distinguishing sales of tangible property from other sales for purposes of P.L. 86-272, there is scant guidance on it from departments of revenue and courts. Much of the relevant litigation has resulted from challenges stemming from the characterization of sales for sales factor apportionment sourcing purposes. For example, in *Ameritech Publishing, Inc. v. Wisconsin Department of Revenue*, Appeal No. 2009, the Wisconsin Court of Appeals held that in determining how a taxpayer should source its sales of phone directory advertisements, the sale was a service and not the sale of tangible personal property. Similarly, *In the Matter of the Appeal of Personal Selling Power, Inc.*, Docket No. 380557 (Calif. SBE, Mar. 16, 2009), the California State Board of Equalization ruled that employees in California soliciting sales of advertisements in a magazine weren't subject to P.L. 86-272 because their activity was a service and not a sale of tangible personal property. However, in *Ameritech Business Information, Inc. v. Department of Revenue*, 650 N.W. 2d 251 (Neb. Sup. Ct., Aug. 16, 2002), the Nebraska Supreme Court held that the compilation and sale of marketing data that were used by businesses to locate new customers was the sale of tangible personal property.

> ***There is virtually no state income tax guidance on the characterization of digital movies, music, and books.***

Distinguishing between tangible and intangible property can also be difficult. In *AccuZip, Inc. v. Division of Taxation*, Docket No. 005744-2003 (N.J. Tax Ct., Aug. 13, 2009), the New Jersey Tax Court held that according to the New Jersey sales tax and federal tax law characterization of software, the taxpayer's licensing of software was the sale of tangible copyrighted property and the taxpayer's activities in the state were protected by P.L. 86-272.

It is interesting to note that there is virtually no state income tax guidance on the characterization of digital movies, music, and books. While states have

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in selling, or soliciting orders for the sale of, tangible personal property for more than one principal and who holds himself out as such in the regular course of his business activities." The law adds that "'representative' does not include an independent contractor"

[3]The MTC has revised its statement of information several times.

remained focused on whether that property constitutes tangible personal property for purposes of imposing sales tax, they have largely left the income tax issues unaddressed.

Ancillary Activities — A Slow Path Forward

While the solicitation of sales of tangible personal property is a protected activity under P.L. 86-272, activities that are entirely ancillary to requests for purchases are also protected. Thus, distinguishing between "ancillary" activities and activities that have an independent nonsolicitation purpose is critical. Although *Wrigley* Court and the MTC statement of information provide some guidance on the types of activities that may be considered ancillary, it is time for revised relevant guidance to address evolving business practices. Approximately 13 states have adopted the MTC's statement of information, and several have modified it.[4] The business community deserves updated guidance that is broadly applicable.

State courts have found the following activities to be protected ancillary activities:

- providing sales order forms and advertising material for a retailer's customers;[5] and
- delivery in company vehicles.[6]

However, the list of activities that courts have found to be unprotected is (not surprisingly) more extensive:

- regular checks of customer inventories;[7]
- swapping stale product;[8]
- buying or selling product;[9]
- visits by credit managers;[10]
- presence of visual merchandising coordinators who set up store signage and point-of-purchase displays, coordinate store inventory levels, and run in-store promotions;[11]
- collecting delinquent accounts;[12]
- investigating customer complaints;[13]
- picking up returned merchandise;[14]
- testing, analyzing, and reviewing product performance;[15] and
- making decisions regarding defective products.[16]

Business models that include activities related to in-state Internet advertising and solicitation should be addressed in order to provide taxpayers meaningful guidance.

The Impact on Combined Reporting

With more states adopting combined reporting, the complexity and importance of the issues associated with *Joyce* and *Finnigan* increase. For purposes of calculating the sales factor numerator of the unitary group in a combined return, states have two distinct positions. Most states have adopted the *Joyce*[17] method whereby each member of the unitary group is viewed separately and its sales are included in the sales factor numerator of the combined group's apportionment formula only if the member (on a stand-alone basis) has nexus in the state or is not protected by P.L. 86-272. Fewer states have adopted the *Finnigan*[18] method whereby the entire unitary group is viewed as one taxpayer and if any one member of the group has nexus in the state or is not protected by P.L. 86-272, then all sales sourced to the state for all members of the group are included in the sales factor numerator of the combined return.

A challenge to the *Finnigan* method was raised in *Disney Enterprises, Inc. v. Tax Appeals Tribunal of the State of New York*, N.Y.3d 392 (N.Y. Ct. of Appeals, Mar. 25, 2008). The New York Court of Appeals held that by including sales from P.L. 86-272-protected companies in the combined group's sales factor numerator. New York was not violating a tax on a protected company. Instead, it was attempting to best measure the combined group's taxable in-state activities. The court rationalized that when Congress enacted P.L. 86-272 in 1959, both formulary apportionment schemes and unitary reporting existed, and nothing in the bill's history suggests that Congress intended to alter the use or applicability of these methods.

California courts have also defended the *Finnigan* method.[19] California reverted to the *Joyce* method before statutorily codifying the *Finnigan*

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[4]MTC Compact member states include Alabama, Arkansas, California, Colorado, District of Columbia, Kansas, Minnesota, Michigan, Missouri, Montana, Oregon, Utah, and Washington.

[5]*Muro Pharmaceutical, Inc. v. Allan A. Crystal, Commissioner,* Docket No. 524693 (Ct. Tax Ct., July 28, 1994).

[6]Maryland Administrative Release No. 2 (Sept. 1, 1999); Nebraska Revenue Ruling No. 24-01-01 (Feb. 22, 2001).

[7]*A.B. Hervey, Jr. v. AMF Beaird, Inc.,* 464 S.W.2d 557 (Ar. Sup. Ct., Mar. 15, 1971).

[8]*The U.S. Tobacco Company v. Mahlon Martin,* 801 S.W.2d 256 (Ar. Sup. Ct., Dec. 17, 1990).

[9]*Id.*

[10]*Kelly-Springfield Tire Company v. Bajorski,* 635 A.2d 771 (Ct. Sup. Ct., Dec. 21, 1993).

[11]Indiana Letter of Findings No. 09-0577 (May 26, 2010).

[12]Idaho State Tax Commission Ruling No. 11270 (Jan. 1, 1999).

[13]*Id.*

[14]*Id.*

[15]*Id.*

[16]*Id.*

[17]*In the Matter of the Appeal of Joyce, Inc.* (66-SBE-070, Nov. 23, 1966).

[18]*In the Matter of the Appeal of Finnigan Corporation* (88-SBE-022, Aug. 25, 1988).

[19]*Deluxe Corp. v. Franchise Tax Bd.,* No. 403-204 (Cal. Ct. App. 2001).

method effective for tax years beginning on or after January 1, 2011. Because of the recent wave of states that have adopted combined reporting along with the *Finnigan* method,[20] further challenges to the *Finnigan* method are all but certain.

Changing State Tax Structures — Income Taxes Versus Gross Receipts Taxes

P.L. 86-272 protects businesses from the imposition of a net income tax while 15 U.S.C. section 383 provides that net income tax is defined as "any tax imposed on, or measured by, net income." States have been adopting new tax regimes that don't fit neatly into a category of a net income tax, gross receipts tax, or anything else. For example, Ohio repealed its corporate income and franchise tax and replaced it with the commercial activity tax, a gross receipts tax imposed on receipts with minimal deductions. Michigan, New Jersey, and Texas also have implemented "alternative" taxes that are similar to a gross receipts tax and a net income tax.

> ***There is some question as to whether taxpayers can still enjoy the protections of P.L. 86-272 in states that impose nontraditional corporate income taxes.***

There is some question as to whether taxpayers can still enjoy the protections of P.L. 86-272 in states that impose nontraditional corporate income taxes. The Texas comptroller of public accounts has taken the position that the Texas margin tax is not a net income tax and that businesses conducting solicitation activities in the state are not protected by P.L. 86-272.[21] However, the Financial Accounting Standards Board has issued guidance providing that the Texas margin tax is an income tax.[22]

In 2001, as part of its business tax reform, New Jersey enacted an alternative minimum assessment (AMA) that was imposed on corporations' New Jersey gross receipts. The AMA was intended to function as a minimum tax on those corporations that were incurring taxable losses and paying no state corporate income tax. However, for tax years beginning on and after July 1, 2006, the AMA applies only to corporations that are protected by P.L. 86-272.[23] Thus, the New Jersey AMA is the only tax in the United States that exclusively targets companies protected from a net income tax under P.L. 86-272.

New state taxes designed in part to avoid the limitations of P.L. 86-272 raise the question whether Congress should consider expanding the law's scope to apply to other taxes.

Conclusion: P.L. 86-272 Revitalized

Although P.L. 86-272 faces continued challenges in today's economic environment, we believe it can be adapted and modernized to provide protection to modern-day businesses. Courts should take a closer look at current business practices and apply the rationale/test provided in *Wrigley* to characterize modern business activities as protected ancillary activities. Congress has left P.L. 86-272 unchanged since its enactment, and it should consider expanding the law to apply to a broader class of taxes. ✰

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Sutherland's SALT Practice is composed of 20 attorneys who focus on planning and controversy associated with income, franchise, sales and use, unclaimed property, and property tax matters. Sutherland's SALT Practice also monitors and comments on state tax legislative and policy efforts.

[20]California, Maine, Massachusetts, and Wisconsin all recently adopted or switched to *Finnigan*.

[21]Rule 3.586 provides that P.L. 86-272 (15 U.S. Code sections 381-384) does not apply to the franchise tax.

[22]FASB meeting minutes of Aug. 2, 2006.

[23]N.J. reg. section 18:7-18.2(b).